

August 27, 2008

Mr. Keith Prescott
Chair, Tax Review Commission
132 West Pierpont Ave. Ste. 250
Salt Lake City, Utah 84101

Mr. David Crapo
Co-Chair, Tax Review Commission
60 East South Temple
500 Eagle Gate Tower
Salt Lake City, Utah 84111

Dear Mr. Prescott and Mr. Crapo:

In the administration of the state's tax laws, the Tax Commission has identified issues that we believe merit serious study and consideration. To that end, the Tax Commission respectfully requests that the Tax Review Commission study the following issues.

1. Foreign Operating Companies. Section 59-7-102 defines a foreign operating company (FOC) as a corporation that conducts 80 percent of its business in foreign countries based on an average of the property and payroll factors. Section 59-7-106 allows a deduction for 50 percent of the income of an FOC. The commission believes that, in order to take advantage of the deduction, a number of companies are setting up abusive structures. These structures typically involve an offshore holding company with minimal employees that appear to handle some minimal bookkeeping or administrative matters, along with a small rental for office space and/or equipment. In fact, it appears that in many cases the individuals serving as employees work for multiple companies. The clear intent in these instances is to create the appearance that a substantive business operation is conducted offshore, when in reality, there are no substantial offshore business operations.

For example, a U.S. company transfers intangible income producing property such as loans, accounts/notes receivable, and other investments into an offshore company, claiming 50 percent exemption of the income as an FOC. The offshore company, with its skeletal operation, merely holds title to the property and receives the income. This tax planning device does not generate income from corporate operations conducted offshore, but merely creates an appearance that the income is generated offshore. In substance, the income is U.S. income and

arose from capital generated from U.S. operations. In addition, the transaction of transferring the property appears to lack substance and is not on an arms length basis.

A number of combined reporting states do not allow any benefit for these types of companies. The commission believes that the amount of abuse and aggressive reporting auditors see in this area justifies elimination of this deduction, and this is the commission's recommendation.

As an alternative, the commission recommends changes to the provisions governing FOC's in an attempt to eliminate the abuses auditors encounter. Amendments to these provisions would include: (1) requiring a high threshold amount of property and payroll to be attributed to the offshore location; (2) excluding from the 50 percent deduction all income generated from any type of intangible property or investment in income reported by any FOC; and (3) clarifying that any intercompany transactions in which the FOC is a party must be eliminated before the exclusion for FOC income is determined.

2. "Business Income" Definition. Section 59-7-302 defines business income as "income arising from transactions and activity in the regular course of the taxpayer's trade or business and includes income from tangible and intangible property if the acquisition, management, and disposition of the property constitutes integral parts of the taxpayer's regular trade or business." The courts have applied divergent meanings to this language. While the agency believes the liquidation of a business constitutes business income under this statute, some courts have concluded that substantially similar language in other state's statutes leads to the opposite conclusion. In this climate of confusion, several states have revised their statutes to more clearly include the liquidation of a business in the definition of business income. The agency believes that Utah should make similar changes to Section 59-7-302.

I appreciate your consideration of these issues and look forward to studying them together with you. Please feel free to contact Bruce Johnson at 297-3905 if you would like further clarification of the issues or our recommendations.

Sincerely,

Pam Hendrickson, Commission Chair